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BANKRUPTCY—PRE-PLAN AUTHORIZATIONS—NORTHERN DISTRICT OF ILLINOIS PROHIBITS FIRST DAY ORDERS AND PRE- PLAN AUTHORIZATIONS FOR PRE- PETITION DEBT

Ryan K. Carney

BANKRUPTCIES today are growing more complex, but are also increasingly more accepted as an option for business survival and competition. As bankruptcy judges have attempted to deal with the realistic problems presented by complex debtors having dozens, if not hundreds, of creditors while attempting to reorganize under Chapter 11 and emerge as healthier business entities, the use of “first day orders” or “pre-plan payments” have allowed them to make practical decisions and keep companies functional.¹ However, in *Capital Factors, Inc. v. Kmart Corp.*,² Judge Grady for the Northern District of Illinois calls this practice into question by ruling that pre-plan payments are prohibited by the Bankruptcy Code.³ Unfortunately for companies faced with reorganization, if higher courts agree with Judge Grady, this highly practical solution may soon see the end of its day in court.⁴ This note will show, however, that Judge Grady’s conclusion is fatally flawed because his analysis does not adequately analyze the Supreme Court’s “doctrine of necessity”⁵ and its effect in conjunction with the Chapter 11 Bankruptcy Code.

Kmart Corp. (“Kmart”), a nationwide supermarket chain, “filed a voluntary petition for reorganization pursuant to Chapter 11 of the . . . Bankruptcy Code” on January 22, 2002.⁶ As is common practice, they immediately filed a motion to authorize payment of “prepetition obliga-

1. See generally *Capital Factors, Inc. v. Kmart Corp.*, 291 B.R. 818, 820-21 (N.D. Ill. 2003) (acknowledging the utility of pre-plan authorizations).

2. *Id.*

3. *Id.* at 822-23.

4. See *id.* at 823 (Judge Grady found that pre-plan authorizations were not authorized in the code and that they were therefore beyond the equitable powers of bankruptcy judges).

5. See *Miltenberger v. Logansport C. & S.W.R. Co.*, 106 U.S. 286 (1882) (approving of certain payments of pre-petition debt to secure critical supplies or services).

6. *Kmart Corp.*, 291 B.R. at 820.

tions to certain 'critical vendors.'"⁷ These vendors were deemed critical for a variety of reasons and included foreign vendors and alcohol suppliers.⁸ It is not entirely clear from the facts that all the so-called "critical vendors" were actually "critical."⁹ Capital Factors, Inc. ("Capital"), an unsecured creditor of Kmart, objected to such payments because they believed that payment of the "critical vendors" would reduce the likelihood that they would recover the more than twenty million dollars they were owed by Kmart.¹⁰ However, "Kmart contended that these payments were necessary to maintain relationships essential to its continued operation and reorganization."¹¹

After hearing evidence on the motions filed regarding the pre-plan payments, the bankruptcy judge ordered the payments over Capital's objections.¹² The bankruptcy judge decided that payment of "critical vendors" was in the best interest of all creditors if it facilitated the process of Chapter 11, but he admitted that bankruptcy judges are "seeing more and more [first day orders for pre-plan authorizations] and . . . have to stretch to find some authority to do them."¹³ Capital appealed that ruling to the Northern District of Illinois claiming, *inter alia*, that pre-plan authorizations are not permissible and that if they are, they were not proper in this case.¹⁴

Although the precedential value of *Kmart Corp.*, is limited,¹⁵ it represents a crucial decision being made in bankruptcy courts today.¹⁶ The court was faced with a run-of-the-mill bankruptcy in which the debtor in possession filed a routine request to pay pre-petition debts to "critical vendors" in order to maintain a functional relationship and pursue the goals of Chapter 11.¹⁷ The court then had to decide, as will future courts, whether the highly practical use of pre-plan authorizations under the "doctrine of necessity" is admissible under the Bankruptcy Code as it stands.¹⁸

The Northern District of Illinois United States District Court holds that pre-plan authorizations, "however useful and practical [they] may appear to bankruptcy courts, they simply are not authorized by the Bankruptcy Code" and are therefore not admissible.¹⁹ Many courts have used 11 U.S.C. § 105(a), which states that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provi-

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.* (quoting App. to Appellee's Brief Ex. 4A, at 162).

14. *See id.* at 821 (discussing issues raised on appeal).

15. The only courts required to follow the Northern District of Illinois District Court holdings are the bankruptcy courts in the Northern District of Illinois.

16. *Kmart Corp.*, 291 B.R. at 820.

17. *Id.* at 820-21.

18. *See generally id.* at 822.

19. *Id.* at 823.

sions of this title,"²⁰ as a basis for their equitable powers to grant pre-plan authorizations.²¹ Judge Grady, however, holds that based on the Seventh Circuit's interpretation that 11 U.S.C. § 105(a) "allows [bankruptcy] courts to use their equitable powers only as necessary to enforce the provisions of the Code," the power to grant pre-plan authorizations does not exist where there is no authorization found in the Bankruptcy Code.²² Judge Grady does admit, however, that "[t]here is a split in the courts regarding whether § 105 authorizes bankruptcy courts to permit pre-plan payment of pre-petition unsecured claims."²³

Both Kmart and Capital are able to cite several courts that would support their arguments, but Judge Grady points out that Capital cites higher authority relative to those cases cited by Kmart.²⁴ Capital is able to claim that three courts of appeals have ruled on similar issues to constrain the equitable powers granted by § 105.²⁵ However, Kmart can rely on a long history of bankruptcy courts using the equitable powers under § 105 in conjunction with the common law "doctrine of necessity" as recognized by the Supreme Court to help entities under Chapter 11 successfully maintain business relationships that are crucial to their future profitability.²⁶

Although Judge Grady bases his opinion on authority that limits the equitable powers granted in 11 U.S.C. § 105 to bankruptcy judges in other related matters,²⁷ his use of that persuasive authority²⁸ is not convincing for several reasons. First, he summarily includes the common law "doctrine of necessity" in with § 105, subjecting it to the restrictions set forth against § 105's equitable powers that were not related to the "doctrine of necessity" and "critical vendors."²⁹ Second, the cases he cites in order to support his conclusion are generally not on point.³⁰ Last and most importantly, when he determines that the Bankruptcy Code does not authorize pre-plan payments, he does not explore the fact that the overriding purpose of Chapter 11 may implicitly justify the equitable so-

20. 11 U.S.C. § 105(a) (2003).

21. See *Kmart Corp.*, 291 B.R. at 822; *In re Just For Feet, Inc.*, 292 B.R. 821, 824 (D. Del. 1999).

22. *Kmart Corp.*, 291 B.R. at 822 (quoting *In re Fresco Plastics Corp.*, 996 F.2d 152, 156 (7th Cir. 1993)).

23. *Id.*

24. *Id.*

25. See *id.* (citing Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299 (4th Cir. 1987); *B&W Enters, Inc. v. Goodman Oil Co.* (*In re B&W Enters., Inc.*), 713 F.2d 534 (9th Cir. 1983); *Chiasson v. J. Louis Matherne & Assoc.* (*In re Oxford Mgmt., Inc.*), 4 F.3d 1329 (5th Cir. 1993); *In re FCX, Inc.*, 60 B.R. 405 (E.D.N.C. 1986); *In re Timberhouse Post & Bean, Ltd.*, 196 B.R. 547 (Bankr. D. Mont. 1996)).

26. *Id.* at 822.

27. *Id.* at 822 (listing cases for discussion of authority).

28. See *id.* at 822 (see cases cited *supra* note 25).

29. *Id.* at 823.

30. See *id.* See *infra* text accompanying notes 37-48.

lution when considered in conjunction with § 105.³¹

The "doctrine of necessity" was acknowledged by the U.S. Supreme Court in the restructuring of railroads³² "as justification for the payment of pre-petition debts paid under duress to secure continued supplies or services essential to the continued operation of the railroad."³³ The doctrine was based on the premise that the public was well-served by continued service of the railroads.³⁴ This doctrine has since been applied to businesses in other industries after Judge Learned Hand "held that a court was not 'helpless' to apply the rule to non-railroad debtors."³⁵ It is common sense that if a business is worth more as a going entity than selling its assets, then the public good is better served by allowing the organization to make the necessary payments to secure the needed supplies and credit for future operations and profitability. Judge Grady here, however, has determined that because this "doctrine is not codified . . . the only way to apply it is through § 105."³⁶ Combining the "doctrine of necessity" in as part of § 105, allows him to minimize it as a factor when he applies cases that restrict equitable powers under § 105.

Although Judge Grady comments that the case law seems stronger in favor of prohibiting pre-plan payments,³⁷ the cases that he has referenced in support of Capital are not controlling authority and for the most part are not on point.³⁸ For example, the court in *Official Committee of Equity Security Holders v. Mabey*,³⁹ does restrict a judge's range of equitable actions, but does not refer to the "doctrine of necessity," nor does it ever address pre-plan authorizations for "critical vendors."⁴⁰ In *Mabey*, former users of the Dalkon Shield, a medical device used for birth control, were suing the manufacturer for infertility caused by its use.⁴¹ The equitable action prevented by the court was the creation of an emergency treatment fund authorizing the debtor to pay for many of the plaintiffs' surgical procedures before the bankruptcy plan was finished.⁴² This action, however generous to the victims, did not affect the debtor's ability to reorganize and continue business operations; therefore, the "doctrine of necessity" was not applicable nor was it discussed.⁴³ The same criti-

31. See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984) (stating "[t]he fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.").

32. See *Miltenberger v. Logansport C. & S.W.R. Co.*, 106 U.S. 286 (1882).

33. *Kmart Corp.*, 291 B.R. at 822 (citing *B&W Enters., Inc v. Goodman Oil Co. (In re B&W Enters., Inc.)*, 713 F.2d 534, 537 (9th Cir. 1983)).

34. See generally *Miltenberger*, 106 U.S. at 286.

35. *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989) (citing Judge Learned Hand from *Dudley v. Mealey*, 147 F.2d 268 (2d Cir. 1945), *cert. denied*, 325 U.S. 873 (1945)).

36. *Kmart Corp.*, 291 B.R. at 822.

37. *Id.*

38. See *id.*; see cases cited *supra* note 25.

39. 832 F.2d 299, 301 (4th Cir. 1987).

40. See *id.*

41. *Id.*

42. *Id.*

43. *Id.*

cism applies to *In re Oxford Management, Inc.*⁴⁴ This case restricted a court's ability to order a debtor to pay a broker's commission based on a tangential legal issue, but the broker was not a "critical vendor" because the services were not ongoing, and again the court did not apply or discuss the "doctrine of necessity" or "critical vendors."⁴⁵ Judge Grady's use of these cases depends upon analogizing one restriction on a bankruptcy judge's power to another, but the analogy is not valid because in *Kmart Corp.*, the equitable power used is supported with the "doctrine of necessity" and the overriding purpose of Chapter 11. The only higher authority relied upon by Judge Grady that even mentions "critical vendors" is *B&W Enterprises v. Goodman Oil Co. (In re B&W Enterprises, Inc.)*,⁴⁶ and the analysis in that case fails to adequately consider the purpose of Chapter 11 and the Supreme Court's "doctrine of necessity."⁴⁷ Thus, the court's analysis in *B&W Enterprises*, as merely persuasive authority, is subject to the same criticism as Judge Grady's analysis in *Kmart Corp.* The case law that Judge Grady finds strong⁴⁸ appears weak when scrutinized in comparison to the actual issues presented in *Kmart Corp.*

Perhaps Judge Grady's most incomplete conclusion is that § 105 prohibits pre-plan payments for "critical vendors" because they are not authorized in the Bankruptcy Code.⁴⁹ This conclusion is based on Capital's argument that the pre-plan payments re-prioritize creditors in a way that is not codified in the Bankruptcy Code because "[t]he Code does not carve out priority . . . for prepetition general unsecured claims based on the 'critical' or 'integral' status of a creditor."⁵⁰ Although pre-plan payment of "critical vendors" may not be explicitly authorized, the entire concept of Chapter 11 implicitly authorizes such payments because "paying certain pre-petition claims may be necessary to realize the goal of chapter 11—a successful reorganization."⁵¹ Chapter 11 exists for the purpose of restructuring entities that are worth more as ongoing concerns than they are if their assets are sold off; a major part of such a determination is based on the assumption that the firm will still be able to conduct business.⁵² The question of the priority of creditors must be second to the survival and reorganization of the entity because the U.S. Supreme Court has held that "the paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated, is the rehabilitation of the debtor."⁵³ As such, the issue is not the priority of debtors repaid,

44. 4 F.3d 1329 (5th Cir. 1993).

45. *Id.* at 1333-34.

46. 713 F.2d 534, 537 (9th Cir. 1983).

47. *Id.*

48. *Kmart Corp.*, 291 B.R. at 822-23; see cases cited *supra* note 25.

49. *Id.* at 823.

50. *Id.* at 822.

51. *In re Just For Feet, Inc.*, 242 B.R. 821, 825-26 (D. Del. 1999).

52. *Id.*

53. *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989) (quoting *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984) which stated "[t]he fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources.").

but the survival and profitability of the reorganized entity enabling all creditors to be repaid.

Clearly there are many situations where a debtor entity will not be able to survive without certain "critical vendors." Historically speaking, one of the most common "critical vendors" would be the debtor's employees, because if the employees were not compensated for past work, they would not continue to work, nor could the debtor hire willing labor in such a situation. "Critical vendor" status could also be met by a vendor that could not survive to supply the debtor if not repaid during the reorganization process. Admittedly, in *Kmart Corp.* there may have been vendors included in the Critical Vendors Motion which were not actually "critical" because the case does not provide facts that prove they were; however, that is not reason to eliminate pre-plan payments for those vendors who are actually "critical."⁵⁴ For instance, in *In re Just For Feet*,⁵⁵ the survival of their chain of shoe superstores required a profitable holiday shopping season, which in turn would require mass shipments of new shoes for inventory from all of the major shoemakers.⁵⁶ These vendors would clearly qualify as "critical vendors," and due to the outstanding debt owed to these vendors, they were not willing to ship additional inventory without payment on outstanding accounts.⁵⁷ Clearly under the premise of Chapter 11, such payments would be implicitly authorized because all creditors, secured and unsecured, would be better served by a profitable holiday shopping season. Fortunately, the Delaware court agreed and found that where the "[t]he Supreme Court, the Third Circuit and the District of Delaware all recognize the court's power to authorize payment of pre-petition claims when such payment is necessary for the debtor's survival during chapter 11," the cases to the contrary represent a minority and misguided opinions.⁵⁸

Being unable to pay "critical vendors'" pre-petition debts when necessary to continue business may spell disaster for future debtors in the Northern District of Illinois due to Judge Grady's unfortunate holding. Although there is valid criticism for judges who refuse to enforce the laws as written, here the purpose of Chapter 11 in conjunction with 11 U.S.C. § 105(a) and the Supreme Court's "doctrine of necessity" clearly support the continued use of pre-plan authorizations for "critical vendors." Furthermore, before prohibiting pre-plan payments, Judge Grady even admits that the "doctrine of necessity" "is well-intended and may even have some beneficial results . . . minimiz[ing] disruptions in doing business and thus may further reorganization."⁵⁹ Hopefully, the Seventh Circuit will reverse Judge Grady on appeal and will articulate carefully for future courts who must consider the viability of this highly practical solution that

54. *Kmart Corp.*, 291 B.R. at 820-21.

55. 242 B.R. 821 (D. Del. 1999).

56. *Id.* at 823-24.

57. *Id.*

58. *Id.* at 825.

59. *Kmart Corp.*, 291 B.R. at 823.

the Supreme Court's "doctrine of necessity" is alive and well, protecting debtors from being forced into liquidation because of the gridlock imposed on them under the Bankruptcy Code.

